SECURITIES EXCHANGE ACT OF 1934
Release No. 36761/January 24, 1996

REPORT OF INVESTIGATION IN THE MATTER OF COUNTY OF ORANGE, CALIFORNIA AS IT RELATES TO THE CONDUCT OF THE MEMBERS OF THE BOARD OF SUPERVISORS

I. INTRODUCTION

The staff of the Division of Enforcement has conducted an investigation into various events in 1993 and 1994 involving material misrepresentations and omissions in connection with the offer and sale of certain municipal securities, including those issued by the County of Orange, California (the "County" or "Orange County"). Six of these municipal offerings by the County collectively raised approximately $1.3 billion and are the subject of this report. These offerings were related to the Orange County investment pools (the "County Pools"),[1] in one or more of the following ways: 1) the proceeds from one of the offerings were reinvested in the County Pools to obtain interest earnings; 2) the funds pledged to repay certain of the securities were invested in the County Pools; 3) the County Pools agreed to repurchase or repay certain of the securities; and/or 4) the County's economic reliance on the County Pools materially affected its ability to repay the securities. The Official Statements for these municipal securities offerings contained material misstatements and omissions concerning the risks relating to, among other things, the County Pools and the financial condition of Orange County, including its ability to repay the securities.

Based upon information obtained during the investigation, the Commission deems it appropriate that it issue this Report of Investigation ("Report") pursuant to Section 21(a) of the Securities Exchange Act of 1934 ("Exchange Act") with respect to the conduct of the individual members of the Board of Supervisors of Orange County, California (the "Supervisors" or "Board members") in authorizing the issuance of these municipal securities.[2]

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1 As discussed below, the County Pools were instrumentalities of the County and were not established as legal entities distinct from the County. The County Pools operated as an investment fund managed by Orange County in which the County and various local governments or districts invested or deposited public funds.

2 Section 21(a) of the Exchange Act authorizes the Commission, in its discretion, to publish information "concerning

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Simultaneous to the issuance of this Report, the Commission has filed and settled a related civil injunctive action against the former County Treasurer-Tax Collector, Robert L. Citron (the "Treasurer"), and the former Assistant Treasurer, Matthew R. Raabe (the "Assistant Treasurer"), pursuant to which they will be enjoined from future violations of the antifraud provisions of the federal securities laws.[3] The Commission has also instituted and settled a related cease and desist proceeding pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 21C of the Exchange Act against Orange County, the Orange County Flood Control District and the Board of Supervisors of Orange County pursuant to which they will be ordered to cease and desist from violations of the antifraud provisions.[4] The Commission's investigation is ongoing.

The Commission is issuing this Report to emphasize the responsibilities under the federal securities laws of local government officials who authorize the issuance of municipal securities and related disclosure documents and the critical role such officials play with respect to the representations contained in the Official Statements for those securities.[5] Public

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[2](...continued)
any . . . violations" and to investigate "any facts, conditions, practices or matters which it may deem necessary or proper" in fulfilling its responsibilities under the Exchange Act. This does not constitute an adjudication of any fact or issue addressed herein. The Supervisors have consented to the issuance of this Report without admitting or denying any of the statements or conclusions set forth herein.

[3] See Securities and Exchange Commission v. Robert L. Citron and Matthew R. Raabe, Civil Action No. _____ (C.D. Cal.).

[4] In the Matter of County of Orange, California; Orange County Flood Control District; and County of Orange, California Board of Supervisors, Exchange Act Release No. _____ (January ___, 1996).

[5] The Commission has previously reviewed disclosure practices of issuers and others in connection with offerings of municipal securities. See Staff of the Securities and Exchange Commission, Staff Report on Transactions in Securities of the City of New York, Transmitted to Subcommittee on Economic Stabilization of the Committee on Banking, Finance and Urban Affairs, House of Representatives, 95th Cong., 1st Sess. (Comm. Print 1977); Final Report in the Matter of Transactions in the Securities of the City of New York, Exchange Act Release No. 15,547, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,936
(continued...)

entities that issue securities are primarily liable for the content of their disclosure documents and are subject to proscriptions under the federal securities laws against false and misleading information in their disclosure documents.[6] In addition to the governmental entity issuing municipal securities, public officials of the issuer who have ultimate authority to approve the issuance of securities and related disclosure documents have responsibilities under the federal securities laws as well. In authorizing the issuance of securities and related disclosure documents, a public official may not authorize disclosure that the official knows to be false; nor may a public official authorize disclosure while recklessly disregarding facts that indicate that there is a risk that the disclosure may be misleading. When, for example, a public official has knowledge of facts bringing into question the issuer's ability to repay the securities, it is reckless for that official to approve disclosure to investors without taking steps appropriate under the circumstances to prevent the dissemination of materially false or misleading information regarding those facts. In this matter, such steps could have included becoming familiar with the disclosure documents and questioning the issuer's officials, employees or other agents about the disclosure of those facts.

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[5](...continued)
(Feb. 5, 1979); Staff Report on the Investigation in the Matter of Transactions in Washington Public Power Supply System Securities, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,327 (1988); Proposal of Exchange Act Rule 15c2-12, Exchange Act Release No. 26,100, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,326 (Sept. 22, 1988); Adoption of Exchange Act Rule 15c2-12, Exchange Act Release No. 26,985, 4 Fed. Sec. L. Rep. (CCH) ¶ 25,098 (June 28, 1989) (the "1989 Release"); Division of Market Regulation, Securities and Exchange Commission, Staff Report on the Municipal Securities Market (Sept. 1993); Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others, Securities Act Release No. 7049 and Exchange Act Release No. 33,741, 7 Fed. Sec. L. Rep. (CCH) ¶ 72,442 (March 9, 1994) (the "March 1994 Release"); Proposal of Amendments to Exchange Act Rule 15c2-12, Exchange Act Release No. 33,742, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,324 (March 9, 1994); Adoption of Amendments to Exchange Act Rule 15c2-12, Exchange Act Release No. 34,961, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,456 (Nov. 10, 1994).

[6] See March 1994 Release; 1989 Release, supra note 5, at 18,199-10 and n.84; see also In re Citisource, Inc. Securities Litigation, 694 F. Supp. 1069, 1072-75 (S.D.N.Y. 1988); Draney v. Wilson, Morton, Assaf & McElligot, 597 F. Supp. 528, 531 (D. Ariz. 1983).

In this case, the Supervisors approved Official Statements that, among other things, failed to disclose certain material information about Orange County's financial condition that brought into question the County's ability to repay its securities absent significant interest income from the County Pools. The Supervisors were aware of material information concerning Orange County's financial condition; this information called into question the County's ability to repay its securities. Nevertheless, the Supervisors failed to take appropriate steps to assure disclosure of these facts. In light of these circumstances, the Board members did not fulfill their obligations under the antifraud provisions of the federal securities laws in authorizing the issuance of the municipal securities and related disclosure documents.

II. BACKGROUND

A. The Orange County Board Of Supervisors

The Orange County Board of Supervisors (the "Board") is the body through which the County exercises its powers.[7] Orange County is a body corporate and politic and has the powers specified in the California (the "State") Constitution, State statutes, and such implied powers as are necessary for the execution of the powers expressly granted.[8] The Board consists of five full-time members, each serving a term of four years. The Board has legislative, financial and police powers. The Board exercises its financial powers through its general supervision of and control over the financial affairs of the County. The powers of the Board include, among others: 1) examination and audit of the financial accounts and records of all officers having responsibility for County moneys;[9] 2) supervision of the official conduct of all County officers, including the Treasurer, "particularly insofar as the functions and duties . . . relate to the assessing, collecting, safekeeping, management or disbursement of public funds";[10] 3) investment and reinvestment of County funds;[11] 4) fiscal powers, including approving the County's proposed budget and

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7 See Board of Supervisors of Modoc County v. Archer, 18 Cal. App. 3d 717, 721, 96 Cal. Rptr. 379, 382 (1971); Cal. Gov't Code § 23005 (West 1988).

8 Cal. Const. Art XI, § 1 (West Supp. 1995); Cal. Gov't Code § 23003 (West 1988).

9 Cal. Gov't Code § 25250 (West 1988).

10 Cal. Gov't Code § 25303 (West 1988).

11 Cal. Gov't Code § 53601 (West Supp. 1995).

adopting the County's final budget;[12] and 5) contracting for County indebtedness,[13] including the issuance of municipal securities.

Although the Board may delegate certain of these duties to County officers and employees, it is ultimately responsible for the execution of these duties. In 1985, the Board formally delegated its authority to invest County funds to its Treasurer.

B. **The Supervisors**

1. **Thomas F. Riley**, age 83, was appointed Supervisor in 1974, elected to the Board two years later, and served continuously through 1994, after which he retired. Riley was the Chairman of the Board in 1994.

2. **William G. Steiner**, age 58, was appointed Supervisor in 1993, elected in 1994, and is currently a member of the Board. His term expires on December 31, 1998.

3. **Roger R. Stanton**, age 58, was first elected Supervisor in 1980, and is currently a member of the Board and its Chairman. His term expires on December 31, 1996.

4. **Gaddi H. Vasquez**, age 40, was appointed to the Board in 1987, elected in 1988, and served continuously until his resignation on September 27, 1995. Prior to his resignation, Vasquez was the Chairman of the Board in 1995.

5. **Harriett M. Wieder**, age 75, was first elected Supervisor in 1978, was Chairman of the Board in 1993 and a member through 1994.

C. **The County Pools And Orange County's Financial Dependence On The Pools**

The County Pools were instrumentalities of the County and were not established as legal entities distinct from the County. The County Pools operated as an investment fund managed by Orange County through which the Treasurer invested public funds deposited by various local governments or districts (the "Pool Participants" or the "Participants"). As of December 6, 1994, the County Pools held approximately $7.6 billion in Participant deposits, including County funds.

Under California law, the Board may delegate its authority to invest or to reinvest County funds to the County Treasurer,

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12 Cal. Gov't Code §§ 29000-29093 (West 1988 & Supp. 1995).

13 Cal. Gov't Code § 25256 (West 1988).

who thereafter assumes full responsibility for such transactions and who must make monthly reports of the transactions to the Board.[14] Pursuant to this law, the Board delegated its authority to invest and reinvest County funds to the County Treasurer. Notwithstanding this delegation of authority, the Treasurer was required to seek approval from the Board for various kinds of investments.[15]

The investment strategy devised by the County Treasurer was risky and was predicated on the assumption that interest rates would remain low. The strategy involved a high degree of leverage through the use of short-term reverse repurchase agreements and a substantial investment in derivative securities of a longer term (including inverse floaters that are negatively affected by a rise in interest rates). For example, on December 6, 1994, when the County Pools held deposits of approximately $7.6 billion, the book value of the leveraged investment portfolios was $20.6 billion.

Orange County's financial condition was closely tied to the financial condition of the County Pools. The County was heavily dependent on the County Pools as a source of income to balance its discretionary budget. The County's discretionary budget was the portion of the County's total budget over which the Board had authority to determine how funds would be allocated.[16] The discretionary budget was also a source of funds for repayment of the municipal securities that are the subject of this report.

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14 See Cal. Gov't Code §§ 53601, 53607 and 53608 (West 1983 & Supp. 1995). See also Cal. Gov't Code § 25303 (West 1988) ("board of supervisors shall supervise the official conduct of all county officers, . . . particularly insofar as the functions and duties . . . relate to the assessing, collecting, safekeeping, management, or disbursement of public funds").

15 For example, at the Treasurer's request in 1985, the Board authorized the Treasurer to engage in reverse repurchase agreements. Additionally, in 1993, the Treasurer sought and received Board authorization to invest in securities with maturities exceeding five years.

16 For fiscal year 1994-95, Orange County's total budget was approximately $3.7 billion. Of that amount, the County was required to spend about 88%, or $3.266 billion, for specific purposes. The remaining 12%, or $462.5 million, comprised Orange County's discretionary budget. The largest portion of the $462.5 million discretionary budget, $162 million, or 35%, was budgeted to come from investment income on Orange County's investment in the County Pools.

The County's use of interest income as a revenue source to balance its discretionary budget had been increasing since at least fiscal year 1991-92, and increased dramatically for fiscal year 1994-95.[17] This increased use of interest income was due to a decline in revenue from other sources, particularly property taxes.[18] By budgeting increased projected interest revenue, Orange County was able to balance its budget and avoid implementing other fiscal measures.

The County had two sources of funds to invest in the County Pools and earn investment interest: its own liquid assets and the proceeds of its municipal securities offerings. From January 1993 to December 6, 1994, Orange County had invested essentially all of its liquid assets in the County Pools, almost $2.3 billion. In 1993 and 1994, Orange County issued $1 billion in municipal securities for the purpose of reinvesting the proceeds in the County Pools.

In early December 1994, the County announced that the County Pools' $20.6 billion investment portfolio had suffered a loss in market value of approximately $1.5 billion. Following liquidation of the portfolio, the County realized a loss of approximately $600 million of its investment in the County Pools. The County also suffered a loss of $157 million in estimated and budgeted interest earnings from the County Pools, contributing to a projected deficit for fiscal year 1994-95 of approximately $172 million. On December 6, 1994, the County filed a petition for bankruptcy under Chapter 9 of the United States Bankruptcy Code. As a result of Orange County's economic dependence on the County Pools and their subsequent collapse, the County has not repaid or repurchased approximately $910 million in municipal securities at the time they were to mature by their original terms or were tendered for repurchase.[19]

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17 For fiscal year 1991-92, interest earnings were $36.8 million, or 7.4% of the discretionary budget; for fiscal year 1992-93, $64.5 million, or 12.4% of the discretionary budget; and for fiscal year 1993-94, they were budgeted at $58.3 million, or 15.1% of the discretionary budget.

18 Property tax revenues comprised 52.8% of the total discretionary budget for fiscal year 1991-92, 49.1% for fiscal year 1992-93, 33.4% for fiscal year 1993-94, and were projected to be only 25.4% for fiscal year 1994-95.

19 These municipal securities have been rated in default by one rating agency. In Orange County's bankruptcy proceeding, the County, the noteholders and the creditors' committee agreed to extend, or rollover, the maturity of approximately $800 million of these municipal securities to June 30, 1996.

III. THE SUPERVISORS AUTHORIZED THE ISSUANCE OF MUNICIPAL SECURITIES IN 1994

A. The Municipal Securities Offerings

In 1994, the County conducted the six municipal securities offerings that are the subject of this report. These offerings were directly related to the County Pools in one or more of the following ways: 1) the proceeds from certain offerings were reinvested in the County Pools to obtain interest earnings; 2) the funds pledged to repay certain of the securities were invested in the County Pools; 3) the County Pools agreed to repurchase or repay certain of the securities; and/or 4) the County's economic reliance on the County Pools materially affected its ability to repay the securities.

The Official Statements for these offerings variously contained material misstatements and omissions of fact regarding: 1) the County Pools, including the County Pools' investment strategy and investment results, and the manipulation of the County Pools' yield, which matters affected the issuer's ability to repay the municipal securities and the County Pools' ability to perform under agreements to repurchase or provide for repayment of the municipal securities; 2) Orange County's financial condition, including its economic reliance on the investment results of the County Pools as a source of funds to repay its obligations on the securities; 3) the tax-exempt status of the offering; 4) an undisclosed cap on the interest rate payable to investors on certain variable rate municipal securities sold in the offerings; and 5) the unauthorized use of an audit report.

1. The Reinvestment Offering

The County conducted one reinvestment offering in 1994, the $600,000,000 COUNTY OF ORANGE, CALIFORNIA 1994-95 TAXABLE NOTES, issued on July 8, 1994. The purpose of this offering was to raise funds to reinvest in the County Pools for profit. In such transactions, an issuer such as Orange County expects to generate profits by investing at a rate of return that is higher than the rate of interest to be paid to the purchasers in the offering.

The County deposited the proceeds from this Reinvestment Offering into an account pledged to repay the notes. The Official Statement for this Reinvestment Offering disclosed that the County intended to invest the pledged funds in the County Pools and that, if an investment loss occurred, the County would satisfy the deficiency from any other moneys lawfully available for repayment. The lawfully available funds consisted essentially of funds in the discretionary budget.

2. The Tax And Revenue Anticipation Note Offerings

In 1994, the County conducted two separate offerings of tax and revenue anticipation notes ("TRANs"), raising a total of $200 million for the purpose of funding cash flow deficits. These offerings were the $169,000,000 COUNTY OF ORANGE, CALIFORNIA 1994-95 TAX AND REVENUE ANTICIPATION NOTES, SERIES A, issued on July 5, 1994, and the $31,000,000 COUNTY OF ORANGE, CALIFORNIA 1994-95 TAX AND REVENUE ANTICIPATION NOTES, SERIES B, issued on August 11, 1994. TRANs are designed to help local governments cover periodic cash flow deficits that arise because they receive revenues infrequently during the year while their working capital expenses remain constant. Such notes are later repaid with the expected tax and other revenue received.

In the Official Statements for these offerings, the County represented that the money pledged to repay the notes would be deposited in the County Pools. The Official Statements further advised prospective investors that, if Orange County suffered an investment loss and the repayment funds were insufficient to repay the notes, the County would satisfy the deficiency from any other moneys lawfully available for repayment. The lawfully available funds consisted essentially of funds in the discretionary budget.

3. The Teeter Offerings

The County conducted two Teeter offerings in 1994: the $111,000,000 COUNTY OF ORANGE, CALIFORNIA 1994-95 (TEETER PLAN) TAXABLE NOTES, issued on July 20, 1994; and the $64,000,000 COUNTY OF ORANGE, CALIFORNIA 1994-95 (TEETER PLAN) TAX-EXEMPT NOTES, issued on August 18, 1994. Separately, the County Pools guaranteed repayment of the Teeter notes pursuant to Standby Note Purchase Agreements. The purpose of the Teeter offerings was to fund the Teeter Plan, which is an alternate method of property tax distribution. Pursuant to this plan, Orange County pays local taxing entities (such as school districts) their share of property taxes based upon levy rather than actual collection. Orange County then retains all property taxes, and the penalties and interest thereon, upon collection.

The Official Statements for the Teeter notes represented that the County planned to invest certain delinquent tax receipts pledged to repay the Teeter Notes in the County Pools. The County Pools also agreed to repurchase the Teeter Notes, through Standby Note Purchase Agreements, which agreements obligated the Treasurer, as fund manager of the County Pools, to purchase the Teeter notes to the extent that there were insufficient funds to repay them. The Official Statements further advised prospective investors that if the repayment funds were insufficient, any deficiency would be satisfied from moneys received under the Standby Note Purchase Agreements and other moneys lawfully

available for repayment. The lawfully available funds consisted essentially of funds in the discretionary budget.

4. The Pension Bond Offering

Finally, in September 1994, the County issued taxable Pension Obligation Bonds for the purpose of funding the County's unfunded, but accrued, pension liability. The Pension Bonds were issued on September 28, 1994, in two series: the $209,840,000 COUNTY OF ORANGE, CALIFORNIA TAXABLE PENSION OBLIGATION BONDS SERIES 1994A; and the $110,200,000 COUNTY OF ORANGE, CALIFORNIA TAXABLE PENSION OBLIGATION BONDS SERIES 1994B. One feature of the Series 1994B bonds was that investors had the right to tender their bonds to a remarketing agent for repurchase. A remarketing agent would attempt to resell the bonds during a seven-day period. If the bonds could not be remarketed, the County Pools, pursuant to a Standby Withdrawal Agreement, stood ready to purchase the tendered securities in an amount up to the County's unrestricted funds in the County Pools, which included funds in the County's discretionary budget.

B. Procedures Regarding Approval Of Municipal Securities Offerings

Final authority to approve each issuance of Orange County municipal securities rested with the Supervisors, pursuant to State law. Short-term financings in which the securities matured in thirteen months or less were submitted to the Supervisors for approval on the Treasurer's recommendation. With respect to debt securities in which the maturities exceeded thirteen months, the County Administrative Officer initiated the recommendation for Board action instead of the Treasurer.

Municipal securities offerings were submitted to the Board for its approval through a document entitled Agenda Item Transmittal, prepared by the Treasurer for short-term note offerings and the County Administrative Officer for long-term bond offerings. The Agenda Item Transmittal typically contained a very brief description of a particular transaction and was sent to the Supervisors three to five business days prior to a Board meeting. For short-term financings, other documents such as a Contract of Purchase, a proposed Board resolution and a draft of a Preliminary Official Statement were also prepared in advance of the Board meeting. These documents were known as "back-up" to the Agenda Item Transmittal.[20]

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[20] The back-up documentation was not always submitted with the Agenda Item Transmittal. In some instances, the back-up documentation was only filed the day before the Board meeting, or was not distributed to the Supervisors' offices (continued...)

For the six offerings discussed in this Report, the Board adopted authorizing and sale resolutions. For each offering, the resolution adopted by the Supervisors: 1) authorized the issuance of the notes or bonds in a specified dollar amount; 2) approved the Preliminary Official Statement in the draft form presented; 3) delegated authority to the Treasurer or the Assistant Treasurer (or, in the case of the Pension Obligation Bonds, to the County Administrative Officer) to: execute a "deemed final" certificate pursuant to Exchange Act Rule 15c2-12; cause the blanks in the Preliminary Official Statement to be filled in and finalize the Preliminary Official Statement; and execute the Official Statement and to deliver the same to the underwriter; and 4) approved the Official Statement for the offering with such revisions as the Treasurer or Assistant Treasurer (or, in the case of the Pension Bonds, the County Administrative Officer) determined were necessary to make the Official Statement true and correct in all material respects.

In addition, the County retained financial advisers, bond counsel and underwriters to assist in these municipal securities offerings. The County also retained a national accounting firm to audit the County's financial statements. The Supervisors approved the retention of these professionals. While the Supervisors believed that they could rely on these professionals, the Supervisors never questioned the professionals regarding the disclosure in the Official Statements, despite their knowledge of facts calling into question the County's ability to repay the securities.

In preparation for Board meetings, the Supervisors and/or their executive assistants attended weekly briefings regarding the items on the upcoming agenda, which might consist of 100 or more items. These briefings generally lasted between one and two hours and were conducted by the County Administrative Officer and/or his staff. Prior to the briefing, the County Administrative Officer reviewed each agenda item, including those concerning the securities offerings, and typically concurred with the recommendations made by the Treasurer. The County Administrative Officer's review was principally focused on ensuring that the agenda item was consistent with both the adopted budget and the Board's policies.

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[20](...continued)
but only to the Clerk of the Board. For example, for two offerings in 1994, the draft Preliminary Official Statements were not filed with the Clerk of the Board until the day before the meeting. For a third offering in 1994, the draft Preliminary Official Statement was filed with the Clerk of the Board on the Friday before the meeting scheduled for Tuesday.

The Supervisors' executive assistants reviewed the Agenda Item Transmittals and occasionally the back-up documentation. The level of review performed by an executive assistant varied considerably, ranging from mere receipt of the Agenda Item Transmittal to reviewing and summarizing both the Agenda Item Transmittal and back-up documentation, when such documentation was available.

The level of review performed by each Supervisor varied. For example, some of the Supervisors reviewed the Agenda Item Transmittal and summaries of the Agenda Item Transmittal back-up documentation; however, no Supervisor recalled reading any of the draft Preliminary Official Statements or related documents. At least one Supervisor did not review any written documentation and instead relied on the County Administrative Officer and his staff and that Supervisor's executive assistant for advice on how to vote.

Each of the six offerings was placed on the Board's "consent calendar" which contained the vast majority of the agenda items. Each of the subject offerings was approved by consent.

IV. THE SUPERVISORS FAILED TO TAKE STEPS TO ASSURE THAT THE COUNTY'S FINANCIAL CONDITION WAS DISCLOSED WHEN THEY AUTHORIZED THE ISSUANCE OF MUNICIPAL SECURITIES IN 1994

Through the formulation and adoption of the County budget, the Supervisors were aware of the County's increasing use of interest earnings from County funds invested in the County Pools as a source of revenue to balance the discretionary portion of the County's budget.

In connection with the budget approval process in fiscal years 1993-94 and 1994-95, the Supervisors were copied on reports from the County Auditor-Controller (the "County Auditor") to the County Administrative Officer discussing the availability of discretionary funds. These documents reported that interest income was a significant factor in balancing the discretionary budget, particularly in 1994.[21]

The first report in 1994 was distributed in February, and referred to the County's use of interest earnings to offset decreases in other revenue sources. Similarly, the May 1994 County Auditor's report cautioned that the projected budget included interest earnings that were "significant," and that the

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[21] In the 1993 County Auditor's reports, the County Auditor stated that one-time revenues, such as certain types of interest earnings, were increasingly being used to balance the County budget and that it was "not fiscally responsible to continue budgeting in this manner any longer."

County could not rely on that source "for the long term." The report further stated that interest earnings had "become an increasingly important source of revenue" and were subject to a variety of factors that may cause such revenue to "fluctuate significantly." The May County Auditor's report concluded by advising that "prudent management of one-time revenues [e.g., certain kinds of interest income] is critical to our investment policies and bond rating."

In the August 1994 County Auditor's report, which was copied to the Supervisors prior to the Pension Bond Offering, the County Auditor asserted that "we should be concerned that interest income . . . [is] financing a significant portion of the budget. The [fiscal year] 1995 interest income projection represents 35 percent of the available financing and is our single largest source of discretionary revenue." Further, the report advised that "[i]nterest income is projected based on increased earnings due to increased taxable and nontaxable borrowings," making clear that, in order to balance the budget, the County was issuing an increasing number of municipal securities offerings in order to obtain increased interest earnings on the investment of such funds.[22]

Despite the use of investment income to balance the County's discretionary budget, the Supervisors testified that they did not understand the investment strategy, the risks of that strategy or the potential risk of loss to the County Pools' principal.[23] However, the Board was provided with certain information regarding the County Pools. This information consisted of the Treasurer's annual financial statements, which statements discussed in general terms the County Pools, including the investment strategy and results. For example, in the September 1993 annual financial statement addressed to, and received by the Board, the Treasurer reported to the Supervisors that the County

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22 The six offerings, raising a total of approximately $1.3 billion, were authorized by the Supervisors during a three-month period in 1994 -- the same three months during which the Supervisors were also in the process of adopting the County's final budget. Further, the municipal securities issued in all but one of the offerings matured one year from the date of their issuance, thereby increasing the significance of the County's current financial condition as it related to the County's ability to repay the securities.

23 During the course of the Treasurer's re-election campaign in the Spring of 1994, the Treasurer's investment strategy was criticized by his opponent as too risky for public funds. The Supervisors were aware of the criticism. The public criticism, however, did not prompt any inquiry or review by the Supervisors.

Pools' strategy involved the use of leverage of approximately 2 to 1 and structured or floating rate securities, and was predicated on interest rates remaining low over the next three years. The Treasurer further advised that the County's investment returns were higher than other local investment pools because of the use of reverse repurchase agreements which added an additional two and one-half percent to the yield. Additionally, the Treasurer also stated that it was his investment policy to hold all securities purchased to maturity, that it was his opinion that interest rates could not be sustained at a high rate and that it was also his opinion that there was no risk of principal loss. In September 1994, the Treasurer reported to the Board that he continued to use reverse repurchase agreements which added an additional two percent yield to the portfolio.

The Treasurer had in prior years submitted to the Board monthly reports of investment transactions, as required by California law; however, he ceased submitting such reports in 1991. The Board took no steps to require the Treasurer to comply with State law and produce the reports.

As a result, the Supervisors failed to have sufficient information concerning the investment of County funds and the impact of the investment of those funds on the financial condition of the County and its ability to repay investors in Orange County's municipal securities.

When the Supervisors approved the 1994 offerings of municipal securities discussed above, they were well aware of the increasing budgetary pressure caused by the declining availability of property tax revenues and other discretionary revenues. Indeed, at least one of the offerings was conducted for the sole purpose of providing additional income to the County. Moreover, the Supervisors were informed that interest projections were based on increased amounts of borrowing.

Despite their knowledge of the County's increasing use of interest income from the County Pools to balance the discretionary budget, the Supervisors approved the Official Statements for the various offerings without taking steps to assure disclosure of this information. They never received or asked to receive a copy of any Preliminary Official Statement once finalized, or any final Official Statement; nor did they question the County's officials, employees or other agents concerning the disclosure regarding the County's financial condition. Thereafter, the Supervisors chose to authorize and approve approximately $1.3 billion of municipal securities offerings.

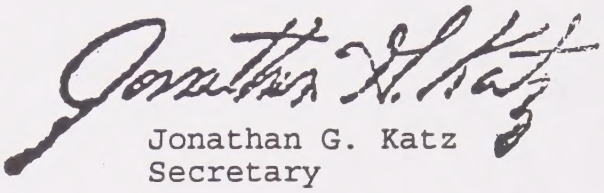
V. CONCLUSION

In addition to the responsibilities imposed on issuers of municipal securities, the antifraud provisions of the federal securities laws impose responsibilities on a public official who authorizes the offer and sale of securities. A public official who approves the issuance of securities and related disclosure documents may not authorize disclosure that the public official knows to be materially false or misleading; nor may the public official authorize disclosure while recklessly disregarding facts that indicate that there is a risk that the disclosure may be misleading. When, for example, a public official has knowledge of facts bringing into question the issuer's ability to repay the securities, it is reckless for that official to approve disclosure to investors without taking steps appropriate under the circumstances to prevent the dissemination of materially false or misleading information regarding those facts. In this matter, such steps could have included becoming familiar with the disclosure documents and questioning the issuer's officials, employees or other agents about the disclosure of those facts.

The Supervisors were aware of the financial condition of the County and that interest income from the County Pools had become a major component of the County's discretionary budget in an environment of increasing budgetary pressure. The Supervisors also knew that the increase in such interest income was connected to the increased amount of County municipal securities offerings and approved at least one offering conducted solely to raise funds for reinvestment. Based on the Supervisors' significant knowledge relating to the County's finances, they should have understood the materiality of that information to the County's ability to repay the municipal securities. The Supervisors therefore had a duty to take steps appropriate under the circumstances to assure accurate disclosure was made to investors regarding this material information. The Supervisors, however, failed to take appropriate steps. For example, while the Supervisors believed that they could rely on the County's officials, employees or other agents with respect to these offerings, they never questioned these officials, employees or other agents regarding the disclosure of this information; nor did they become familiar with the disclosure regarding the County's financial condition. Had they taken such or similar steps, it should have been apparent to each Supervisor, in light of his or her knowledge, that the disclosure regarding the County's financial condition may have been materially false or misleading.

Consequently, the Supervisors failed to assure appropriate disclosure of these matters by authorizing and approving the dissemination of misleading disclosure documents. This failure denied investors the fair and accurate disclosure required under the federal securities laws.

By the Commission.



Jonathan G. Katz
Secretary